ETNO Statement on the WACC Notice of the European Commission

The European Commission issued a notice in November 2019[1] (the Notice) which outlines the methodology for the calculation of the Weighted Average Cost of Capital (WACC) of legacy assets and mandates BEREC to annually calculate the various individual input parameters. Although the Notice is non-binding, National Regulatory Authorities (NRA) within the EU might have little discretion to deviate from it as they would risk a serious doubts procedure under Art. 32 of the European Electronic Communications Code (EECC). Thus, the Notice and the BEREC calculations will directly affect national tariff decisions and, as an important benchmark for fibre returns, will also send strong signals for fibre investments. Therefore, the impact of the WACC notice on investment decisions cannot be underestimated.

A wrongly set WACC for legacy assets poses serious threats for electronic communications markets in Europe. It would send negative signals to investors and reduce trust in regulation as it shows that Regulators would not take into account investors expected return on investments or current challenges of Corona crisis and furthermore, they would allow for disruptive decreases. Legacy WACC decisions could spill over to VHC where the legacy WACC is perceived as benchmark or basis for VHC WACC. Contrary to the Commission's intention to promote the internal market the Notice may create distortions to EU internal market as countries with bigger differences with the actual WACC figures for the telecommunication sector would be penalized.

Therefore, it is of utmost importance that the recommended methodology is not flawed and delivers values which are in line with market expectations. If amended properly, a more harmonized WACC would indeed provide the opportunity for a fair and simplified WACC setting throughout Europe.

Yet, ETNOs analysis shows that the Notice and BEREC's first calculations[2] (the Report) have several technical flaws that result today in underestimated WACC levels for SMP operators who operate legacy networks, sometimes in a very severe way for some operators.

ETNO, in this context, calls for an urgent review of the EC notice to amend the technical flaws and its resulting regulatory framework to achieve for the future a fair remuneration of legacy assets and to avoid detrimental signals for fibre investments.

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[1] Communication 2019/C 375/01 of 6.11.2019

[2] Report BOR (20) 116 of 12 June, 2020

A. Major flaws of the Commission Notice

1. **Resulting national WACCs are out of line with investor's expected return on investment and lead to disruptive decreases beyond what could have been expected by the previous NRA methodology.**

   First applications by NRAs in Europe show **unreasonably low WACC values** (2,9% pre-tax real terms in Germany; 4,8% pre-tax, nominal in France) which would translate into WACC **decreases** of **34%** for Germany and **37%** for France. Such values fall significantly short of standard ranges of values of the cost of capital of the telco sector as seen by financial analysts or by investors.

2. **Pure historic perspective of ERP leads to wrong ERP estimates and goes against the forward-looking nature of CAPM.**

   ETNO is in favor of using the Capital Asset Pricing Model (CAPM). We deeply regret however that the Notice and Report fail to recognize the **forward-looking** nature of the CAPM model when proposing their concrete steps to estimate the cost of equity.

   The Equity Risk Premium (ERP) is a key parameter within the CAPM formula and expresses the excess return expected to invest in equities e.g. the average expected return of shares over and above risk free assets, e.g. government bonds. The EU approach of **pure historical data** conflicts with state-of-the art analysis of financial analysts and economists from the European Central Bank (ECB) or other central banks in Europe which use **forward looking approaches** and leads to a severe underestimation of the ERP.

   This underestimation is most significant in countries where the effects of QE (Quantitative Easing) are the most visible.

3. **Combination of EU ERP with national risk-free rate creates methodological inconsistency and results in underestimated expected returns on EU equity markets for all countries.**

   The notice mandates the usage of a single **uniform** ERP to be calculated by BEREC for all Member States. Then, the Notice suggests to combine the EU ERP with a **national** risk free rate. That does not adequately reflect national risks as it reduces national risk differences to differences in government credit ratings. It also uses risk free rates inconsistently by using different values for national risk-free rates within the ERP calculation and for the national WACC calculation. It leads to an underestimation of expected returns on EU equity markets for all countries by combining a historical ERP with local interest rates that are depressed by QE.

4. **The RFR methodology of a 5-year averaging period does not capture the effects of the ECB's monetary policy (QE) and results in extremely low interest rates.**

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The notice recommends calculating the risk-free rate (RFR) based on the 5-year averages of the 10 year sovereign bond of each Member State. This methodology captures as a result the effects of QE on sovereign EU interest rates and results in **depressed values** for the estimate of RFR. Despite the initial views[3] of the Commission and the recommendation from the Commission's Brattle study[4], the Notice deemed that "an adjustment for central bank quantitative easing programs is not necessary".

5. **The cost of debt as per the Notice underestimates the cost of historical debt incurred to finance legacy assets. It also does not include the cost of hybrid debt nor the corporate debt purchases made by the ECB (CSPP).**

   Both the Notice and Report wrongly assume that legacy assets can be refinanced under terms comparable to those of the past five years, while in fact these assets have been developed and financed in much older periods. As a result, the resulting cost of debt may **underestimate the actual legacy debt** related to these assets.

B. Necessary amendments in the WACC Notice

1. **Consistency checks** with **financial analysts'** estimates of EU expected market returns, as well as WACC estimates of **operators** should be obligatory for BEREC and the NRAs. These checks should be done, at the macro-level, with estimates of EU expected cost of equities and ERPs; and at the company specific level, with financial analyst estimates of the company cost of debt and WACCs which would be significantly higher than current estimates as per the Notice and first Report.

2. In particular, consistency checks for ERP's comparing historical DMS data with **forward looking methodologies** based on dividend discount models, and with published sources of forward-looking ERPs, such as surveys or other usually cited sources of ERPs such as Damodaran's studies[5] and Fernandez's surveys[6].

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[3] See Commission's background document to the public consultation in 2018: "*NRAs could adjust their estimate of the RFR to account for quantitative easing (QE) programs, as there is evidence that they have depressed bond yields*", even though it deemed that "*adjustments for QE introduce an element of unpredictability into the estimation of the RFR*".

[4] Brattle Group (2016): Review of approaches to estimate a reasonable rate of return for investments in telecoms networks in regulatory proceedings and options for EU harmonization, https://bit.ly/2LyobXW.

[5] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3653512&download=yes

[6] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3560869&download=yes

3. Set a **mark-up on the ERP or the RFR** if analysis under 1 and 2 shows inconsistency: Adjust upwards the risk-free rate used to calculate the cost of equity if historical data for the ERP is used. A suggested way would be to use "Normalized" estimates of the risk-free rate considering the target level of inflation in the EU. Such a level would be of **2% or even more** if inflation expectations for the medium term increase due to possible changes in monetary policy or the macro-economic conditions. The adjustment per country would be obtained as the difference between the observed level of interest rates and the Normalized level. Typically, the resulting adjustment would be higher in countries where the QE programs have the most depressing effects on sovereign yields. This QE adjustment should be calculated taking as averaging period for the national risk-free rates a 10 year window to smooth out the effects of QE. This approach should result in an **upward adjustment** of the risk-free rate of typically 100 to 200 basis points **(1% to 2%)**[7].

4. In addition, the RFR should be adjusted upwards to calculate the risk-free rate to consider the **longer maturity prospective** of equity investments as opposed to a **10-Year** bond.

5. Check consistency of the cost of debt calculation with the **actual cost of debt of companies** including all sources of debt.

6. Consequently, Notice should **mandate BEREC to perform additional analysis** and publish these findings:
    a. for the ERP estimate using forward looking models, collecting alternative estimates for the ERP (e.g. by economic studies, national auditing institutions, independent estimates based on dividend discount models, surveys) and to publish these findings
    b. publish 10 year averages for national risk free rates
    c. collect investor's and financial analyst's views on expected return on investment on a company level
    d. perform alternative calculations for the cost of debt using CDS and IRS (interest rate swap (IRS) , the credit default swap (CDS)) on the basis of the results obtained for operators for whom such a calculation is feasible.

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[7] For instance, if a country shows a five-year average of the RFR at 0,5% then the QE adjustment would be at 2%-0,5% = 1,5%. If the 10 year average is 1,4%, then the QE adjustment would be 0,6%. A longer averaging period smooths out the effects of QE and reduces the magnitude of QE adjustment. No adjustment would be needed to the RFR if observed data is above the normalized rate.